

**Internal Revenue Service**  
**LMSB-Director, International**  
**Tax Treaty Office**

**Tax Treaties and the**  
**U.S. Competent**  
**Authority**

July 31, 2003

# Basic Purpose of Tax Treaties

To facilitate international trade and investment by removing tax barriers.

Example – Provide reduction in tax rates for specific categories of income (e.g., dividends)

# Types of Agreements

- Income Tax Treaties
- Estate and Gift Tax Treaties
- Tax Information Exchange Agreements
- Shipping and Aircraft Agreements
- Social Security Agreements
- Mutual Legal Assistance Treaties

# IRS Link

- For copies of U.S. Tax Treaties, visit the IRS web site at:  
<http://www.irs.gov/businesses/corporations/article/0,,id=96739,00.html>

# MAP Article

- Mutual Agreement Procedure (MAP)  
Article authorizes the “Competent Authorities” of each “Contracting State” to resolve “doubts and difficulties” and to attempt to “eliminate double taxation.”

# Competent Authority Office

- All U.S. Tax Treaties contain a Mutual Agreement Procedure (MAP) Article
- Director, International delegated as U.S. Competent Authority
- Tax Treaty Office
  - Assists taxpayers in obtaining treaty benefits
  - Resolves interpretative matters (with Counsel)
  - Eliminates double taxation
  - Coordinates exchange of certain information

# Definition of Double Taxation

- Economic Double Taxation – Two countries tax income from a controlled transaction between related companies. Example: If the U.S. proposes to increase the royalty rate on a royalty paid to a U.S. Parent company from its foreign Subsidiary, then, without an offsetting adjustment to increase the Sub's royalty expense, the company on a whole would suffer economic double taxation.

# Definition – cont'd

- Juridical Double Taxation – Two countries tax the same taxpayer on the same income.

Example: If two countries treat an individual as resident of their respective country, then both countries tax the earnings of that individual.

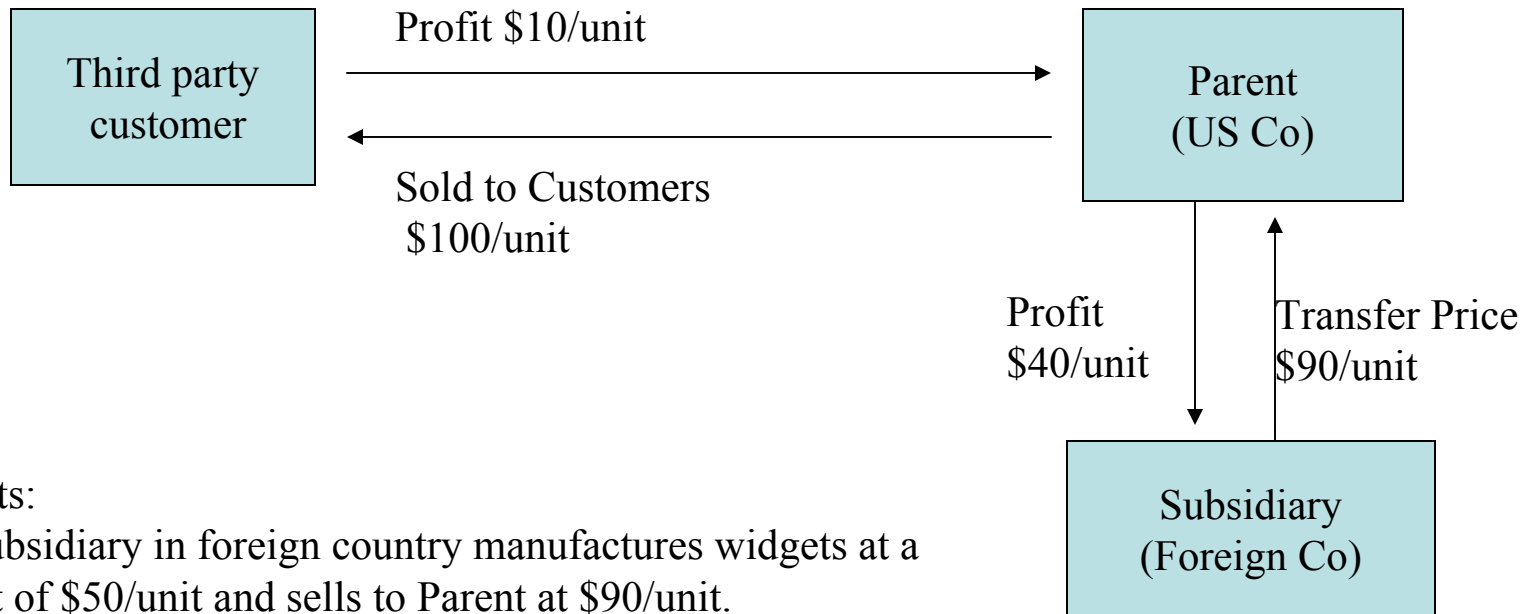
# MAP Process

- U.S. or Treaty Country initiates a transfer pricing adjustment resulting in double taxation
- Taxpayer and its affiliate(s) request Competent Authority assistance
- Competent Authority staffs meet to discuss facts and negotiate resolution
- Mutual agreement concluded to relieve double taxation

# MAP Process –cont'd

- Field examination personnel notified of Competent Authority determination
- Returns adjusted accordingly
- Information exchanged through Fed/State program

# Transfer Pricing Example



## Facts:

- Subsidiary in foreign country manufactures widgets at a cost of \$50/unit and sells to Parent at \$90/unit.
- U.S. Parent sells widgets to unrelated customers for \$100/unit.
- Upon audit, arms-length sales price to Parent determined to be \$55/unit (rather than \$90/unit).
- Assume tax rates are: 35% in US; 10% in foreign country

# Example –cont'd

- Per return (transfer price of \$90) -  
U.S. Parent tax liability on \$10 profit is \$3.5  
(Sales of \$100 less \$90 COGS). Foreign Sub  
tax liability on \$40 profit is \$4 (Sales of \$90 less  
\$50 COGS). Worldwide tax liability is \$7.5
- Per audit (transfer price of \$55) -  
U.S. Parent tax liability on \$45 profit is \$15.75  
(Sales of \$100 less \$55 COGS). Foreign Sub  
tax liability on \$5 profit is \$0.5 (Sales of \$55 less  
\$50 COGS). Worldwide tax liability is \$16.25

# Competent Authority Statistics

- Summary of year end inventory:

<u>FY</u>	<u>Cases Rec'd</u>	<u>Cases Closed</u>	<u>YE</u>
1999	205	228	425
2000	228	175	478
2001	210	189	499
2002	212	228	483

# Statistics – cont'd

- Competent Authority relief (based on percentage of total dollar adjustment) -

Relief	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Correlative Adj.	28%	27%	25%	38%
Adj. Withdrawn	39%	72%	48%	27%
Partial Relief	3%	0%	3%	27%
No Relief	29%	1%	24%	9%

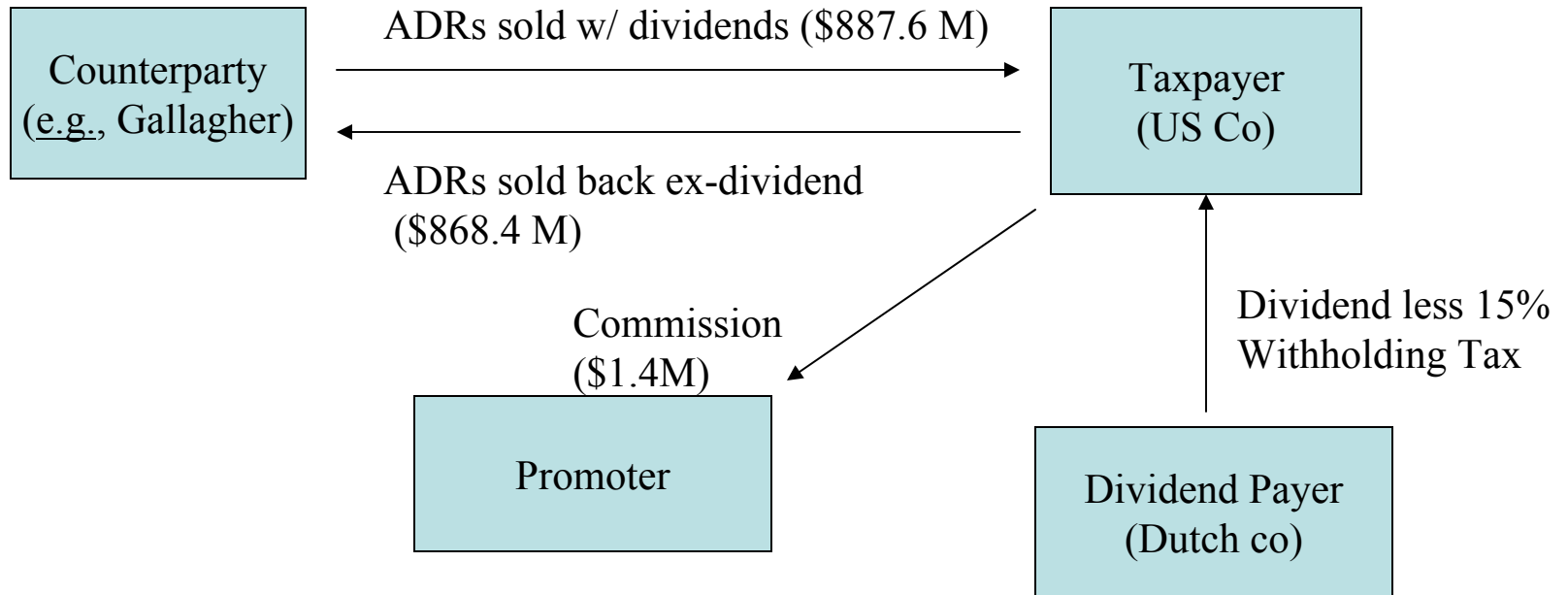
# MAP Issues of Interest

- Abusive Corporate Tax Shelter request
- FTC on Computer Software

# Abusive Corporate Tax Shelters

- Dividend Arbitrage Issue (similar to Compaq litigation)
- Dutch Withholding on Dividend
- Taxpayer claimed FTC
- U.S. Denied FTC
- U.S. Denied C/A Assistance

# ADR Arbitrage Transaction



# Arbitrage – con't

- Tax return:  
\$20.6 Capital Loss on sale of Stk.  
\$22.5 Dividend Income  
\$3.4 Withholding tax to Dutch (15%)
- Cash flow:  
\$20.6 Loss on sale  
\$19.1 Dividend income net of w/h tax  
\$ 1.5 Net economic loss
- Benefit Received:  
-\$7.9 U.S tax on dividend income ( $22.5 \times 35\%$ )  
\$7.2 Tax savings by loss offset ( $20.6 \times 35\%$ )  
\$3.4 FTC relief  
\$2.7 US tax benefit

# Software Characterization

- Sale vs Licensing
  - In U.S., payment for software is sale
  - Many foreign countries view payment as royalty (“license” to use) and withhold on payment
- Taxpayers claim FTC on w/h tax paid
- No FTC allowed on “voluntary” payments
- Issue for examiners: disallow FTC claimed for w/h tax on “Royalties”
- C/A negotiate characterization based on facts